

THE PHASES OF REGULATIONS: THE CFTC PROPOSES IMPLEMENTATION SCHEDULES FOR CLEARING, TRADE EXECUTION, TRADING DOCUMENTATION AND MARGIN REQUIREMENTS

September 19, 2011

To Our Clients and Friends:

The Commodity Futures Trading Commission (the “CFTC”) recently issued proposed rules to establish implementation schedules for the clearing and trade execution requirements under Section 2(h) of the Commodity Exchange Act (the “CEA”) and the swap trading relationship documentation and margin requirements under Section 4s of the CEA.

Comments must be submitted within 45 days of the publication of the proposed rules in the Federal Register. The proposed rules may be found on the CFTC’s website at:

<http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankProposedRules/index.htm>

With these implementation schedules, the CFTC proposes to phase in compliance with the clearing, trade execution, trading documentation and margin requirements to:

- provide certain market participants with more time to bring their swaps into compliance, particularly for those market participants that manage third-party subaccounts;
- give adequate time to market participants to educate their clients about the new requirements; and
- ensure the involvement of an adequate cross-section of market participants from the beginning of the implementation of the new regulatory regime.

To achieve these goals, the CFTC intends to implement the regulatory regime by phasing in various categories of market participants. This categorization takes into consideration the market participants’ level of market experience, status as registrants with the CFTC or the Securities and Exchange Commission (the “SEC”), and existing resources and infrastructure to comply with the requirements.

CATEGORIES OF MARKET PARTICIPANTS

With respect to the implementation schedules for the clearing, trade execution, trading documentation and margin requirements, the CFTC proposes two categories of market participants:

- Category 1 Entities are defined as (i) swap dealers, (ii) security-based swap dealers, (iii) major swap participants, (iv) major security-based swap participants and (v) active funds.

Category 1 Entities are given the least amount of time to comply with the requirements because they have more market experience than other market participants and are required to be registered with the CFTC or the SEC.

An active fund is any private fund, as defined in section 202(a) of the Investment Advisers Act of 1940 (the “Advisers Act”), that is not a third-party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding the CFTC’s issuing final determination for mandatory clearing of swaps or the publication in the Federal Register of the final rules for trading documentation or margin requirement, as applicable. The CFTC proposes to include active funds in the earliest phase of implementation to include a “buy-side” representation in the regulatory regime.

- Category 2 Entities are (i) commodities pools, (ii) private funds as defined in section 202(a) of the Advisers Act (other than active funds), (iii) employee benefit plans as defined in paragraphs (3) and (32) of the Employee Retirement Income and Security Act of 1974, (iv) persons predominantly engaged in activities that are in the business of banking or in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956, except that all third-party subaccounts are excluded from Category 2.

Category 2 Entities are given more time to comply with the requirements because they are less experienced in and less frequent users of the swap markets than Category 1 Entities and may not be required to be registered with the CFTC or the SEC.

A third-party subaccount is defined as a managed account that requires specific approval by the beneficial owner of the account to execute documentation necessary for executing, confirming, margining or clearing swaps.

With respect to the implementation schedules for the trading documentation and margin requirements only, the CFTC proposes two additional categories of market participants:

- Category 3 Entities are Category 2 Entities whose positions are held as third-party subaccounts.

Third-party subaccounts are given more time than the other market participants because their portfolios are managed by asset managers that must bring numerous accounts into compliance through a process that requires approval from their beneficial owners.

- Category 4 Entities are entities other than Category 1, 2 and 3 Entities.

CLEARING REQUIREMENT

The clearing requirement of the CEA makes it unlawful for any person to engage in a swap that is required to be cleared, unless that person submits such swap for clearing to a derivative clearing organization that is either registered under the CEA or exempt from registration. The only counterparty-based exception to the clearing requirement is the proposed “end-user exception” for swaps when one of the counterparties is not a financial entity, is using the swap to hedge or mitigate commercial risk, and notifies the CFTC how it generally meets its financial obligations under the uncleared swap.

Otherwise, with respect to each swap, the CFTC is responsible for determining whether it must be cleared either by initiating a review of the swap or reviewing submissions from derivative clearing organizations of each swap, or any group, category, type or class of swaps that the derivative clearing organization intends to clear. Although the CFTC will make self-initiated clearing determinations, initial clearing determinations are expected to be based on swaps that are already being cleared or on submissions from derivative clearing organizations to reflect the market’s view that such swaps are ready to be cleared.

Under the proposed Section 39.5(e), after the effective date set by the CFTC for a mandatory clearing determination, compliance with the clearing requirement will be phased in for swap transactions:

- between a Category 1 Entity and another Category 1 Entity, or any other entity that desires to clear the transaction, within 90 days;
- between a Category 2 Entity and a Category 1 Entity, another Category 2 Entity, or any other entity that desires to clear the transaction, in no later than 180 days; and
- for all other swap transactions, including those with third-party subaccounts, that are not eligible to claim the end-user exception, in no later than 270 days.

The CFTC expects to use the implementation schedule when a mandatory clearing determination is made for a new group, category, type or class of swaps. It is unlikely that the implementation schedule would be used for a new swap that is in the same group, category, type or class of swaps covered by a previously issued mandatory clearing determination. Moreover, the CFTC has the discretion to use the implementation schedule only when it believes it is necessary to achieve the goals outlined above.

TRADE EXECUTION REQUIREMENT

The trade execution requirement in the CEA requires the counterparties to any swap subject to the clearing requirement to execute the swap transaction on a board of trade designated as a contract market under Section 5 of the CEA or on a swap execution facility registered under Section 5h of the CEA (or a swap execution facility exempt from registration under Section 5h(f) of the CEA). The only exceptions to the trade execution requirement are (1) if the swap is excused from the clearing requirement under the end-user exception and (2) if no designated contract market or swap execution facility makes the swap available for trade.

Under proposed Sections 37.12 and 38.11 of the CFTC's regulations, the implementation schedule for the trade execution requirement is tied to the implementation schedule for the clearing requirement. The trade execution requirement for a swap is triggered upon the later of:

- the applicable deadline established under the implementation schedule for the clearing requirement; or
- 30 days after the swap is made available for trading on either a designated contract market or swap execution facility.

TRADING DOCUMENTATION REQUIREMENTS

The trading documentation requirements in Section 23.504 of the CFTC's regulations are proposed in connection with Sections 4s(i)(1) and (2) of the CEA, which require the CFTC to promulgate rules for documentation standards for swap dealers and major swap participants.

Under the proposed trading documentation requirements, swap dealers and major swap participants must (1) establish, maintain and enforce written policies and procedures designed to ensure the written documentation of the terms of swap trading relationships, including (a) terms relating to payment obligations, netting, events of default or other

termination events, transfer of rights and obligations, governing law, valuation (from execution to termination, maturity or expiration) and dispute resolution procedures, (b) confirmations of swap transactions and (c) credit support arrangements between counterparties, and the execution of all required agreements; (2) comply with certain additional documentation requirements for bilaterally-executed swaps subsequently submitted for clearing to a derivative clearing organization; and (3) include a provision in the trading documentation, which confirms that both parties understand how the new orderly liquidation authority under the Dodd-Frank Act and Federal Deposit Insurance Act may affect their portfolios of uncleared, bilateral swaps.

Under proposed Section 23.575 of the CFTC's regulations, after the date the trading documentation requirement is published in the Federal Register, swap dealers and major swap participants are phased into compliance with such trading documentation requirement for swap transactions with:

- a Category 1 Entity, in no later than 90 days;
- a Category 2 Entity, in no later than 180 days; and
- a Category 3 Entity or a Category 4 Entity, in no later than 270 days.

MARGIN REQUIREMENTS

The margin requirements in Sections 23.150-23.158 of the CFTC's regulations are proposed in connection with Section 4s(e) of the CEA, which requires the CFTC to promulgate rules establishing margin requirements for swap dealers and major swap participants that are not banks.

Under the proposed margin requirements, swap dealers and major swap participants for which there is no prudential regulator (*i.e.*, "covered swap entities") must (1) document the credit support arrangements and specific material terms regarding margin calculation and thresholds, the types of assets that may be posted and where margin will be held, (2) comply with specific margin requirements based on whether the counterparty is another swap dealer or major swap participant, a financial entity or a non-financial entity and (3) comply with provisions regarding the calculation of initial margin and variation margin, forms of margin and custodial arrangements.

Under proposed Section 23.175 of the CFTC's regulations, from the date the margin requirement is published in the Federal Register, covered swap entities are phased into compliance with such margin requirement for swap transactions with:

- a Category 1 Entity, in no later than 90 days;
- a Category 2 Entity, in no later than 180 days; and
- a Category 3 Entity or a Category 4 Entity, in no later than 270 days.

Under each of the proposed implementation schedules outlined above, voluntary compliance with the clearing, trade execution, trading documentation and margin requirements is permitted sooner than required by the respective implementation schedule.

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